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SUBJECT: MINORITY GOVERNMENT HAS ITS PRICE -- PREMIERS COME OUT ON TOP IN TRANSFER PAYMENT DEAL

REF: A) HALIFAX B) 04 OTTAWA 3215 C) OTTAWA 105

1. (SBU) SUMMARY: The GOC reached an agreement in principle on January 28 with the provinces of Nova Scotia and Newfoundland & Labrador in the ongoing dispute over offshore oil and gas revenue and equalization payments. The provinces were the clear winners, with an eight-year renewable deal to keep 100% of their share of offshore revenue, with no clawback on equalization payments, plus a cash bonus. The deal effectively amounts to double-dipping, since equalization payments are intended in part to compensate resource-starved provinces. But given the reality of minority government, the PM had little choice but to resolve this major distraction in order to stabilize his position in Atlantic Canada. Following the concept of asymmetric federalism, which was advanced in the health-care deal in September (ref tel B) this concession increasingly politicizes otherwise technical fiscal issues and opens the door for other provinces to push their agendas, some of which are already citing the Atlantic agreement as precedent. END SUMMARY

PREMIERS COME OUT ON TOP

2. (SBU) The Government of Canada has reached an agreement in principle with the Provinces of Nova Scotia and Newfoundland & Labrador, in an effort to end the ongoing fight over offshore oil revenue and equalization transfer payments. The deals were made after a day of meetings in Ottawa on January 28. Premier Danny Williams of Newfoundland & Labrador and Premier John Hamm of Nova Scotia met with Prime Minister Paul Martin, Finance Minister Ralph Goodale and Minister of Natural Resources John Efford, Newfoundland's only Cabinet Minister.

3. (SBU) It appears that PM Martin made significant concessions in these negotiations. For at least eight years, the province's entitlements to equalization payments from the GOC will not be reduced by their receipts from offshore oil and gas royalties. The timeline imposed by the federal government is open for extension, the Premiers were given up-front payments, and Ottawa apparently dropped its demand that the provinces balance their budgets as a precondition to any deal. Other provincial leaders -- Saskatchewan, Premier Lorne Calvert, the Northwest Territories, Joe Handy, and Ontario, Finance Minister Greg Sobara -- quickly cited the Atlantic agreements as a precedent in arguing that they should get a special deal.

4. (SBU) To counter the perception that the provinces are double-dipping, the federal government demanded an eight-year limit be imposed on the agreement, so the provinces still have an incentive to permanently improve their fiscal outlook. In previous attempts to negotiate a deal, a timeline was strongly opposed by Premier Williams, who argued that if at the end of eight years Newfoundland had not yet acquired have, status, the rug would be effectively pulled out from under its feet and any progress lost. In this agreement, the deal will be reviewed for possible renewal at the end of 2012.

5. (SBU) These are Canada's most indebted provinces and even with the equalization payments and this offshore revenue deal it is not certain that they will achieve fiscal strength. Ottawa is expecting a large surplus this year, with smaller amounts in the next few years so the lump-sum arrangement makes sense in that regard. The offshore revenue amounts are in addition to the October equalization deal (ref) that raised federal transfers for FY05 and FY06 by C\$274 million (US\$220 million) for Newfoundland and Labrador and C\$333 million (US\$266 million) for Nova Scotia.

6. (SBU) Under the agreement, Newfoundland and Labrador will receive about C\$2.6 billion (about US\$2 billion) from FY2005-2012, with C\$2 billion (US\$1.6 billion) up front. Newfoundland and Labrador has a heavy debt burden, and unfunded pension liabilities come to over 20% of provincial GDP (much higher than other provinces). Debt service is approximately C\$2,000 per capita, according to a private sector analyst. Use of the offshore revenue prepayment will probably be clarified in the upcoming budget. One option the Premier has proposed is creation of a trust fund that could

be drawn down when needed.

17. (SBU) Nova Scotia gets C\$830 million (US\$664 million) up front of an estimated C\$1.1 billion (US\$880 million) over the next 8 years. Premier Hamm has committed the total amount to debt retirement, which should free up C\$45-50 million (up to US\$40 million) a year in interest payments. The Prime Minister told national media that his primary motivation in the negotiations was to find a way to assist two provinces with unique situations and significant budgetary problems. These substantial, one-time payments help the PM assert that he is working for immediate solutions.

A SWEET DEAL GETS SWEETER

18. (SBU) Media reports also indicate the federal government dropped its demand that the provinces balance their budgets as a requirement for an agreement. An unnamed federal official attending the recent Liberal caucus retreat, said the federal government would not include this demand in its negotiating position. A balanced budget would not have been a major challenge for Nova Scotia, but Premier Williams indicated it would have placed a considerable burden on Newfoundland and Labrador. Balanced budget demands were rejected by the Premiers in September,s Health Summit and were a key factor in William,s walkout from negotiations in December.

19. (SBU) Commentators in the national media speculate that the GOC,s status in Parliament was an important factor in this negotiation, beginning with Martin,s promise to Premier Williams in June which he made to win electoral support in Newfoundland and Labrador; his willingness to deal is tied to maintaining the support of the province,s seven MPs. The deal will also, of course, be helpful in a future election, when Prime Minister Martin will be able to say that he not only negotiated a deal which was praised by the provincial Premiers, but cut the checks up front.

110. (SBU) Comment: It appears at first blush that Premiers Williams and Hamm were the victors in this contest, getting a pretty good fiscal deal with few outright concessions. But by eliminating this distraction before the start of Parliament and regaining some support in Atlantic Canada, the PM did not come away empty handed, and given his minority status, could be said to have simply done what he had to do in the short term. It remains to be seen what impact this will have on the federal-provincial equation in the future. It seems clear that by making another &asymmetrical federalism8 arrangement Martin has further complicated the equalization transfer payment system, and opened the door for claims by other provinces seeking special deals. Whether this can be contained to a technical fiscal question, or whether it weakens the structure of the entire federal system, remains to be seen.

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